

LB&I International Practice Service Concept Unit

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Unit Name	Branch Profits Tax Concepts
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General Overview

Branch Profits Tax Concepts

The branch profits tax provision under IRC §884(a) treats a U.S. branch of a foreign corporation as if it were a U.S. subsidiary of a foreign corporation for purposes of taxing profit repatriations. As such, IRC §884(a) puts the earnings and profits of a branch of a foreign corporation deemed remitted to its home office on equal footing with the earnings and profits of a U.S. subsidiary paid out as a dividend to its foreign parent.

IRC §884(a) was enacted as part of the Tax Reform Act of 1986 as a substitute for “second-tier withholding on dividends” under IRC §861(a). Section 861(a) treated a foreign corporation as paying U.S. source dividends if more than 50% of the foreign corporation’s income was effectively connected with a U.S. trade or business for the three prior years. This second-tier withholding tax was difficult to administer because the foreign corporation became a U.S. withholding agent but the percentage of the dividend resourced depended on the percentage of its gross income that was effectively connected income (ECI) for the three prior years. Most U.S. income tax treaties in effect at that time exempted those dividends from U.S. withholding tax, and they did so based on the address of the foreign recipient. Prior to 1986, nearly all of the treaties lacked “limitation on benefits” articles. Thus, the second-tier withholding tax was not an effective means of collecting tax. A foreign corporation could transfer the profits of its U.S. branch to its home office without incurring any tax legally by treaty, or even absent a treaty, with little risk of being detected, because the withholding agent was a foreign corporation, not a domestic corporation. In contrast, a U.S. subsidiary would be subject to a dividend withholding tax on a payment to its foreign parent of at least 5% under a treaty, and 30% absent a treaty.

As a result of the enactment of IRC §884(a), the branch profits tax is calculated and paid by the foreign corporation on a Form 1120-F (U.S. Income Tax Return of a Foreign Corporation). The tax applies regardless of whether the U.S. trade or business of the foreign corporation is substantial compared to its worldwide activities. It treats the U.S. trade or business of the foreign corporation as if it were incorporated as a subsidiary of the foreign corporation and deems the profits of the subsidiary to be remitted, pursuant to a formula, to the foreign corporation at the end of the year. It eliminates the competitive advantage in operating as a branch vis-à-vis a subsidiary with respect to repatriation of profits. Moreover, the branch profits tax computation’s formulary nature strongly discourages the use of branch operations because it takes away control of the timing of the payment of the dividend equivalent amount. For example, a subsidiary can declare and pay a dividend on any date during its taxable year, but a branch must pay it only at year end.

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General Overview (cont'd)

Branch Profits Tax Concepts

Additionally, in many cases, if the foreign corporation conducts any business outside the U.S. a branch will be deemed to pay a larger dividend than a subsidiary even if it reinvests all of its profits back into the branch. Thus, shortly after the branch profits tax was enacted in 1986, many companies chose to reorganize and incorporate their U.S. branches or terminate them to avoid the complex rules that apply to determine the base on which the branch profits tax is imposed.

It is important to understand the theory of the branch profits tax, which is to put the earnings and profits of a branch of a foreign corporation deemed remitted to its home office on equal footing with earnings and profits of a U.S. subsidiary paid out as a dividend to its foreign parent. Although it was quite a novel idea when enacted, since intra-company transfers are not respected for other purposes of the Code, there was precedent in other countries. IRC §884(a) imposes the same rate of tax on deemed remittances to a home office (30% or lower treaty rate) as on dividends paid by a U.S. subsidiary to a foreign parent.

While it is simple to compute dividends declared and paid by a subsidiary, it is not so simple to measure the earnings and profits of a branch deemed remitted to its head office. Branches do not declare and pay dividends. Instead branches remit funds via intra-company transfers, which are similar to moving money from one pocket into another. Rather than tracking these intra-company remittances, however, Congress decided to impose the tax on a formulary basis, treating the branch as effectively operating with the same debt/equity ratio as the foreign corporation as a whole.

Generally, a foreign corporation must be engaged in a U.S. trade or business to be subject to the branch profits tax and have ECI. Nonresident alien individuals and complex trusts are never subject to the branch profits tax. A foreign corporation can have ECI by either engaging in a U.S. trade or business itself, or electing to be treated as so engaged, (for example, a foreign corporation may elect under IRC §882(d) for its real property income to be treated as income from a U.S. trade or business). Even if a foreign corporation does not make the election under IRC §882(d), but owns U.S. real property, it will be subject to the branch profits tax if it has ECI under IRC §897 on the disposition of a U.S. real property interest, other than ECI from a gain from the sale of a U.S. real property holding corporation (USRPHC). Additionally, a foreign corporation that is a partner in a partnership, or beneficiary of a trust or estate, is subject to the branch profits tax if the partnership, trust, or estate is engaged in a U.S. trade or business to the extent of the foreign corporation's distributive share of income of the partnership, trust, or estate that is treated as ECI in its hands. If the branch profits tax is applicable, there is no additional tax on any dividend distributions made by the foreign corporation.

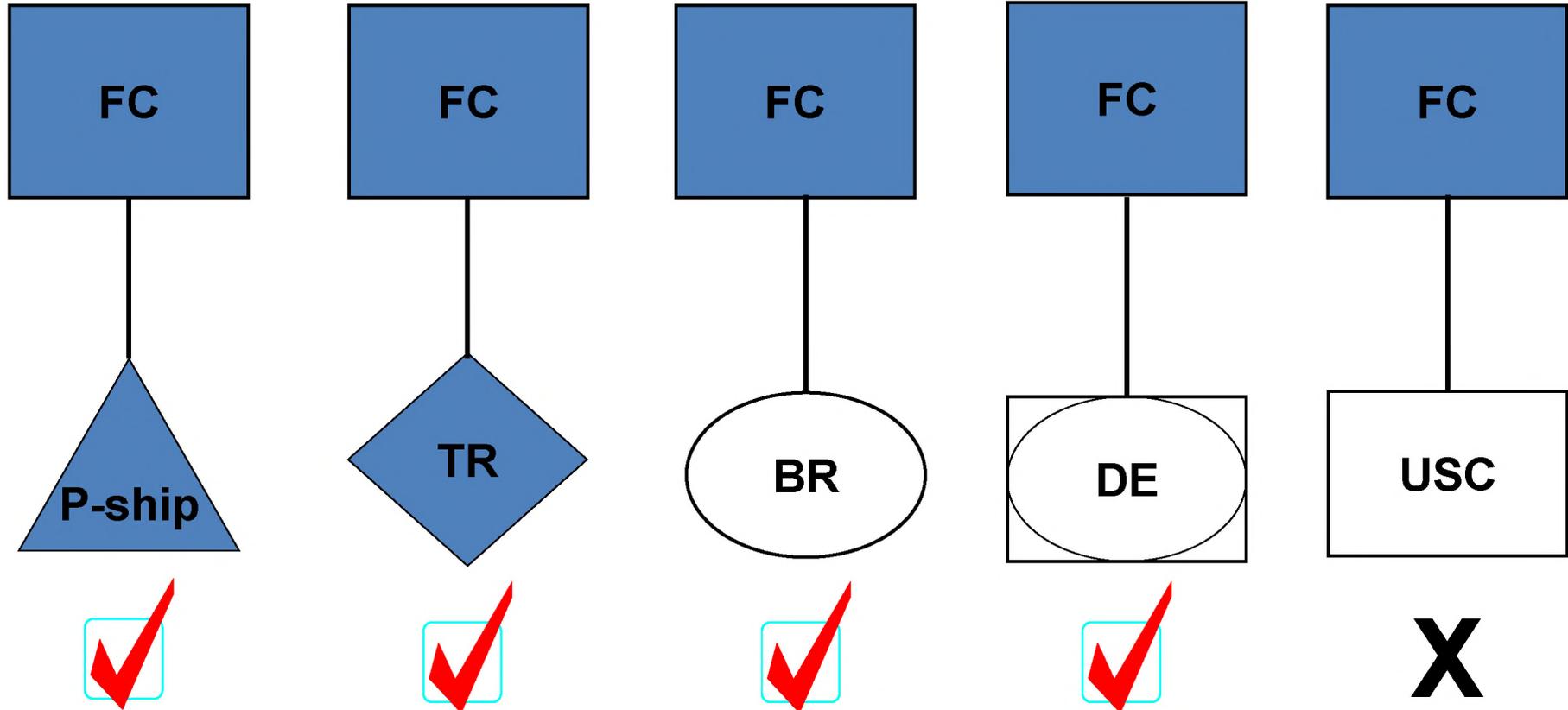
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Diagram of Concept

Branch Profits Tax Concepts

Diagram of Concept

Does the branch profits tax apply?



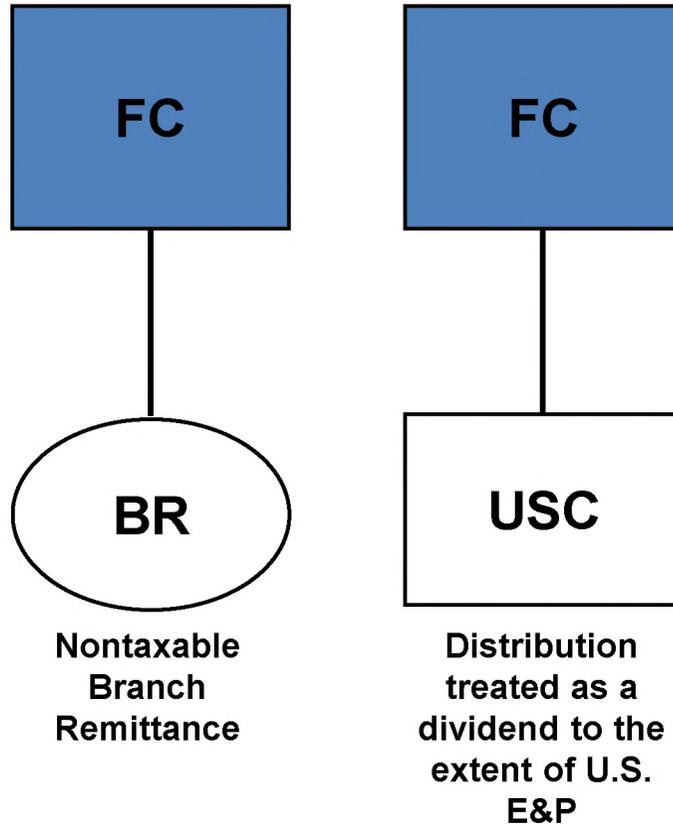
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Diagram of Concept (cont'd)

Branch Profits Tax Concepts

Diagram of Concept

Pre-1986 Tax Reform Act (TRA) Branch Advantage



- Investment in branch form was especially favorable pre-86 TRA.

Subsidiary – 2 Levels of Tax

- Earnings taxed under IRC §11 or §55.
- Dividend to FC subject to withholding under IRC §1441/§1442.

Branch – 1 Level of Tax

- Earnings taxed under IRC §882.
- Remittance to FC not subject to tax.

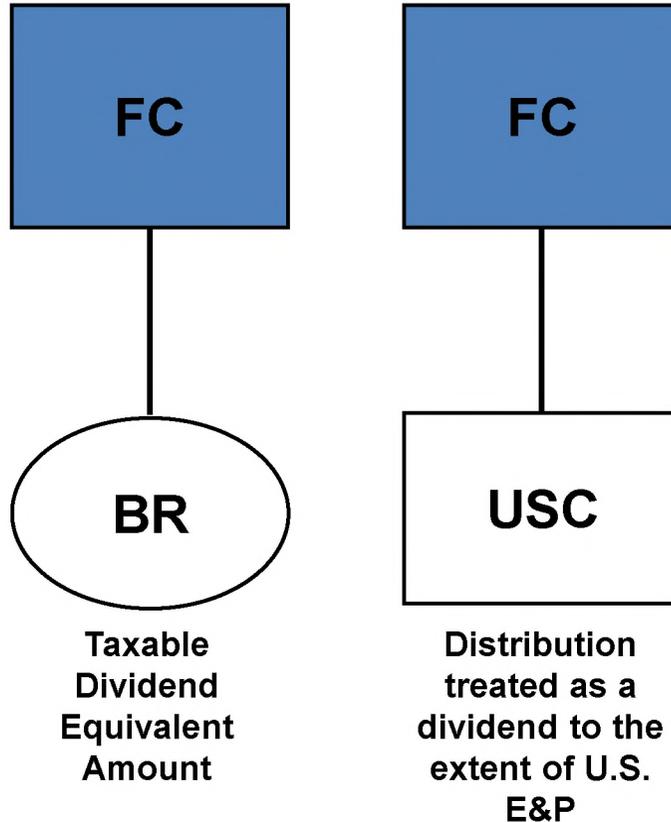
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Diagram of Concept (cont'd)

Branch Profits Tax Concepts

Diagram of Concept

Post-1986 Tax Reform Act Branch Equalization



- Equalizes the tax treatment of FC's U.S. investment through a subsidiary and through a branch.
- Imposition of 30% branch profits tax on the dividend equivalent amount (DEA) – may be reduced by a treaty.
- Branch profits tax applies in addition to IRC §882 tax imposed on branch's effectively connected taxable income (ECTI).

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Detailed Explanation of the Concept

Branch Profits Tax Concepts		
Analysis	Resources	6103 Protected Resources
<p>Because of the enactment of IRC §884(a), foreign corporations with U.S. branches are subject to two levels of tax: at the entity level when the U.S. branches earn income, and at the shareholder level when the earnings are repatriated. The purpose of IRC §884(a) is to impose a second-level tax on branches of foreign corporations in addition to the usual tax imposed on income effectively connected with a U.S. trade or business under IRC §882.</p> <p>The branch profits tax imposes a 30% tax on the after-tax earnings of a foreign corporation’s U.S. trade or business that are not reinvested in such U.S. trade or business. The branch profits tax is equal to 30% (or lower treaty rate) of the “dividend equivalent amount” or DEA. As such, the branch profits tax provision treats a U.S. branch of a foreign corporation as if it were a subsidiary of a foreign corporation. The DEA is a U.S. branch’s effectively connected earnings and profits (ECEP) for a taxable year reduced by the increase in a U.S. branch’s U.S. net equity (USNE) or increased by a U.S. branch’s decrease in USNE. USNE equals U.S. assets minus U.S. liabilities. The DEA is similar to dividends paid by a subsidiary either out of current E&P not yet invested or out of accumulated E&P invested in subsidiary assets. The DEA, therefore, can be eliminated only if the USNE increases by the amount of the ECEP of the branch each year. There are two ways to increase USNE: use the profits to purchase additional U.S. assets, or elect to reduce U.S. liabilities. Branch income that is reinvested in qualifying branch (U.S.) assets is not considered repatriated to the foreign home office. On the other hand, if branch income is not reinvested in qualifying U.S. assets, then it is deemed repatriated. If a foreign corporation has no other business besides its U.S. business, then the management of the DEA is not difficult. If it does have other assets and liabilities that are not U.S. assets or U.S. liabilities, the formulary nature of USNE makes it extremely hard to continuously increase USNE by the amount of ECEP for the taxable year.</p>		

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Detailed Explanation of the Concept (cont'd)

Branch Profits Tax Concepts

Analysis	Resources	6103 Protected Resources
<p>As stated previously, foreign corporations that have a trade or business in the U.S. may be subject to tax under IRC §882, which imposes tax at the normal corporate tax rates under IRC §11. A foreign corporation has ECI if it is engaged in a trade or business within the U.S. and has income connected to that trade or business. A foreign corporation that performs services in the U.S. is engaged in a trade or business in the U.S. and has ECI. Additionally, a foreign corporation that sells products on a regular and continuous basis in the U.S. is engaged in a trade or business in the U.S., but in order for its income to be ECI, title of the products must pass to the buyer in the U.S., or the sale must be attributable to a U.S. office.</p> <p>Generally, ECI must be from U.S. sources. Certain foreign source income may be ECI, but only if it is described in IRC §864(c)(4)(B). Effectively connected taxable income (ECTI) (ECI less expenses) is taxed at U.S. graduated rates per IRC §11. Deductions are allowed to the extent connected to the business of foreign corporations pursuant to IRC §882(c).</p> <p>If a foreign corporation is a resident of a treaty country and otherwise qualifies for treaty benefits (meets a “limitation on benefits” article, if any), it will not be taxed on its ECI unless it has, or is deemed to have, a permanent establishment (PE) in the U.S. Generally, a foreign corporation has a U.S. PE if it has a fixed place of business in the U.S., a construction site in the U.S. that lasts a certain number of months, or it carries on business through a dependent agent authorized to enter into contracts in the name of the foreign corporation. If the foreign corporation does not have a PE in the U.S., it will not be subject to the branch profits tax.</p>		

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Detailed Explanation of the Concept (cont'd)

Branch Profits Tax Concepts		
Analysis	Resources	6103 Protected Resources
<p>If a foreign corporation has a PE, but its ECI is not entirely attributable to the PE, the branch profits tax will apply to only the ECEP attributable to the profits of the PE, and not to any other profits. As noted above, U.S. income tax treaties generally reduce the rate of the branch profits tax to the same rate that applies to direct dividends. This rate is generally 5% unless the U.S. has negotiated a treaty or protocol since 2002 that reduces the direct dividend rate to zero (very limited number of treaties). To qualify for the full exemption, the foreign corporation must meet not only the treaty's "limitation on benefits" article but also additional requirements in the dividend or branch profits tax articles. For the few treaties that have not been renegotiated since January 1, 1987, the foreign corporation must be a qualified resident within the meaning of Treas. Reg. §1.884-5. Those regulations provide analogous tests to prevent treaty shopping as do "limitation on benefits" articles. If a foreign corporation is a qualified resident under a treaty, no branch profits tax will apply because the tax was effectively acknowledged by the regulations as violating the non-discrimination article of the treaties, unless the treaty already allowed the other state to impose its branch profits tax. See Treas. Reg. §1.884-1(g).</p> <p>A taxpayer must file a Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) with its Form 1120-F to disclose the basis on which it is claiming a reduced rate or exemption from the branch profits tax under a tax treaty (but not under IRC §884). If a taxpayer fails to file a Form 8833 a penalty of \$10,000 is imposed under IRC §6712.</p>		

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Training and Additional Resources

Branch Profits Tax Concepts		
Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"> ▪ 10/24/2012 – Jurisdiction to Tax/Form 1120-F Slides for CENTRA Class ▪ 03/14/2013 – IBC Form 1120F Audit Tips & Tools Module 7 	<ul style="list-style-type: none"> ▪ Partnership Withholding with 1120-F Partners ▪ 1120-F Case Study Module 7 – Branch Profits Tax
Other Training Materials	<ul style="list-style-type: none"> ▪ 07/11/2012 – Branch Profits Tax Network Call 	<ul style="list-style-type: none"> ▪ 884 - Branch Profits Tax Network Call

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Glossary of Terms and Acronyms

Acronym	Definition
BR	Branch
DE	Disregarded Entity
DEA	Dividend Equivalent Amount
ECI	Effectively Connected Income
ECEP	Effectively Connected Earnings and Profits
ECTI	Effectively Connected Taxable Income
FC	Foreign Corporation
FIRPTA	Foreign Investment in Real Property Tax Act
PE	Permanent Establishment
P-ship	Partnership
TR	Trust
TRA	Tax Reform Act
USC	U.S. Corporation
USNE	U.S. Net Equity
USRPHC	U.S. Real Property Holding Corporation

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Index of Related Issues

Issue	Associated UIL(s)	References
Fundamentals of gross effectively connected income (ECI)	<ul style="list-style-type: none"> ▪ 9422.01 – U.S. Branch Allocations (Non-Treaty ECI Determinations) 	<ul style="list-style-type: none"> ▪ Effectively Connected Income (ECI) Fundamentals ▪ DCN: To Be Determined ▪ Unit Under Construction
<ul style="list-style-type: none"> ▪ If it is determined that a taxpayer has effectively connected income from a trade or business within the U.S., the taxpayer should file a Form 1120-F tax return. 	<ul style="list-style-type: none"> ▪ 9422.01-01 – Determination of proper income allocation 	<ul style="list-style-type: none"> ▪ Gross Effectively Connected Income (ECI) of a Foreign Corporation (Non-Treaty) ▪ DCN: ISI/9422.01_01(2013)
<ul style="list-style-type: none"> ▪ Discussion of requirements for beneficial owner to claim a reduced rate or exemption from withholding and the branch profits tax under a treaty. 	<ul style="list-style-type: none"> ▪ 9424.01-06 – Payee claims for relief under a tax treaty 	<ul style="list-style-type: none"> ▪ FDAP Payments/Branch Profits Tax - Treaty Benefits -Qualified Resident under Treaty/Limitation on Benefits ▪ DCN: TBD ▪ Unit Under Construction
<ul style="list-style-type: none"> ▪ The computation of the Dividend Equivalent Amount is covered and includes discussion of how increases/decreases in U.S. Net Equity and non-previously taxed accumulated ECEP impact the computation. 	<ul style="list-style-type: none"> ▪ 9424.02 – Branch Profits Tax 	<ul style="list-style-type: none"> ▪ Branch Profits Tax - Dividend Equivalent Amount (DEA) ▪ DCN: TBD ▪ Unit Under Construction
<ul style="list-style-type: none"> ▪ Provide example where agent will need to review a specific treaty for the article that provides for a reduced rate of withholding with respect to the branch profits tax and the branch-level interest tax. 	<ul style="list-style-type: none"> ▪ 9450.07 – Determination of appropriate treaty withholding rate 	<ul style="list-style-type: none"> ▪ Determination of appropriate treaty withholding rate: Branch profits tax and branch-level interest tax ▪ DCN: TBD ▪ Unit Under Construction